Taking Royalties "In-Kind": The Federal Perspective

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The concept of taking natural resource royalties "in-kind" is not a new idea. In spite of its current buzz with industry it is centuries old. It is the most primitive form of the royalty concept itself. More than a thousand years ago when royal landowners found indentured servitude was not meeting their needs for raw materials, they contracted with independent miners to do it. The miners, who were probably the leading entrepreneurs of their day, found the arrangements attractive. The contractual arrangement between royals and the miners was that the miners would be allowed to exploit the royal resources as long as they provided a share of the production to the Crown. These first royalties were clearly in-kind. The ancient Greeks, medieval Germans, Saxons, and Normans all took their royal share of mineral production from their lands in-kind. The concept of paying the royal owners "in-value" with cash for mining their lands is a much more modern construction. As economies grew and progressed, the gold, silver, copper, tin, iron, mercury, etc. that was mined became more valuable to the crown for what they could buy rather than for their practical uses. Over the broad sweep of time, shifting relative costs for labor, transportation, information, market access and financial transactions probably played a role in the move from in-kind to in-value royalty collection. That is to say, it became easier, more convenient and cheaper for the King to take cold cash over production.

Today both systems can be found in all corners of the world. The United States has long recognized the royalty in-kind option. All Federal leases contain a provision that allows the Secretary to elect to take the Federal royalty in-kind. Some versions of Federal leases over

history actually gave the lessee the option to pay their royalties in-kind. Few, however, did. Over all these years it usually made sense for the government to take a cash royalty payment.

Until now? Even the most casual observer will note the dramatic transformations in our economy over the last 25 years: computers, information, automation, telecommunications, financial services, deregulation, as well as the increasing complexity and sophistication of markets, and the commercial enterprises that operate in them. We all are repeatedly bouncing off satellites. The way the oil and gas industry does business today also has changed markedly. Transactions costs have declined, and assets can change hands several times a day. Real time market information is readily available to everyone. There is no doubt that changes to the economy over this time have shifted the relative costs of activities associated with mineral production, sale and royalty collection. These economic changes suggest that it is worth taking another look at the way the Federal government collects its royalties. Indeed, other countries are rediscovering the possibility of "in-kind" royalties. The Canadian Province of Alberta with their Crude Oil royalty in-kind program is one relevant example. Has the royalty issue in the US finally come full circle? Have all the economic factors re-aligned in such a way as to make taking royalties in-kind the efficient choice once again? Maybe. What MMS recognizes is that current conditions strongly suggest that we thoroughly examine the royalty in-kind (RIK) issue through analytical study and practical tests.

Since its inception in 1982, MMS has consistently sought to be an active and progressive steward of the Federal royalty interest. In keeping with the Administration's goal of re-inventing government, MMS thought that the RIK concept might be an effective way of changing and

improving the way the Federal government does business and should be studied. Given the changes in the economy and our commercial structures, will RIK allow us to do our job more effectively and at lower cost to the taxpayer? Can we eliminate a lot of unproductive administrative activity for both government and for the companies we allow to extract oil and gas from Federal land? Is it more efficient? Perhaps.

MMS is now entering the next phase of its examination of the RIK concept. The ground work has been laid over the last four years. From the planning and implementation of a pilot program in 1995, through a careful examination of that pilot's results, to a further study of the concept's feasibility, MMS is now prepared to implement three new RIK pilot programs. Before we discuss the planning of these new pilots, it is useful to go back and examine what we have done and what we have learned to date regarding RIK.

The 1995 Royalty Gas Marketing Pilot was the first attempt to look at the potential benefits of an RIK system. The objectives of that pilot were to test RIK's ability to streamline royalty collections, improve royalty management efficiencies, and provide greater certainty in royalty collections while achieving revenue neutrality. The pilot was essentially a voluntary collaboration with 14 participating producers that lasted 1 year. It accounted for 45.6 bcf of gas from 79 leases. We had competitive bidding for 36 small lease groups where the bids were tied to applicable indices. MMS continued to audit producers' shares. At the end of the pilot's year, MMS estimated the revenue loss at $4.7 million, or 6.5% of revenues, and $0.0974/MMBtu. If these results were applied to the entire Gulf of Mexico, the projected lost revenue would total $82 million per year.

But the pilot was a success for many other reasons. MMS's purpose behind the pilot was to learn more about operating an RIK program. The best way to do that is by practical experiment. By trying it, and taking it from a solely academic discourse, MMS learned a great deal. MMS learned that the specific way competitive bidding is structured is critical to its success. Timing and procedures all play a role. We now know that the pilot's structure did not allow enough preparation time for both MMS and bidders, and the contractual terms were less comprehensive than we believed and often proved ambiguous. We learned that voluntary lease participation is not advantageous to the Federal Government. It left us with dispersed production and reduced our ability to aggregate, which is instrumental to maximizing value. Limiting ourselves to sales at the collection point led to lower revenues due to lack of downstream value uplift, and high transportation rates were paid for movement on non-jurisdictional lines.

Even though the pilot lost money, MMS still felt RIK had potential to improve royalty management. We gained a better understanding of what works and what doesn't work as well as what we should avoid the next time around. MMS therefore continued to move forward and commissioned a study looking at the feasibility of implementing RIK across all Federal oil and gas leases.

The 1997 RIK Feasibility Study, which intensively examined offshore and onshore Federal crude oil and natural gas RIK potential, required the better part of a year to complete. Its objective was to see if an RIK program could be constructed that would meet the interests of taxpayers while meeting industry's need for administrative relief. Clearly, this would require that the program offer revenue neutrality and reduce administrative costs for both industry and government. A

secondary objective was to assess whether MMS could, through active management and marketing, enhance royalty revenue much the way industry does with its own production. Looking at the issue from a macro perspective, the Feasibility Study focused on isolating the geographical, infrastructural, and commercial conditions that would control an RIK program's success or failure.

As part of the process, MMS received information at six public meetings and workshops, collected written comments from many interested parties, and interviewed market participants and surveyed the gas marketing industry. We examined pipelines and transportation systems, and historical royalty data. The Study then distilled all this information down, combined it with our experience with the 1995 RIK pilot and analyzed it relative to the Federal interest.

Perhaps the most significant finding of the Feasibility Study was that RIK could be workable, increase royalty revenue, and be potentially more efficient under the right conditions. The Feasibility Study found that the benefits of an RIK program would come from a reduction in the audit and administrative burden. Reducing the costly appeals process and the litigation of royalty disputes is an important source of savings. The study also determined that producers would have to continue to place oil and gas production in "marketable condition" before the Federal royalty share was collected. This, as you know, is also a feature of the current royalty "in-value" system and is required through the lease terms. MMS would also need the ability to market production to customers downstream of the royalty delivery point. We would also need the ability to aggregate production to be able to deliver economically and commercially attractive quantities of oil and/or gas to our customers.

The areas of concern for a potential RIK program would be existing pipeline capacity, the distribution of leases in a program, small volume leases, and transportation rates along non-jurisdictional lines. Circumstances that would force MMS to sell into imperfectly competitive market structures would fail to produce full market value and have a negative impact on royalty revenue. The Feasibility Study indicated that any program that mandated RIK across all Federal oil and gas leases was not found to be in the interests of the taxpayer.

The Feasibility Study summed up by suggesting that an RIK program in certain areas could be successful if structured in a way that accounted for the potential pitfalls and allowed MMS the flexibility to market the production as necessary to maximize value to the taxpayer. The study then recommended that we test this assertion through another series of pilots. Three new RIK pilot programs were proposed. The first, a small oil RIK pilot in the State of Wyoming, the second, an RIK pilot covering "8(g)" production offshore Texas, and third, a large rand more complex pilot which would take natural gas from offshore leases in the Gulf of Mexico. Both Texas and Wyoming have actively expressed interest in pursuing an RIK program in their areas.

The management of MMS accepted the basic recommendations of the Feasibility Study and decided to move forward with the development of the three RIK pilot programs. The implementation of the recommended pilots involved setting up a task force encompassing personnel from all MMS divisions. Fifteen senior MMS experts, who will devote the majority of their time over the next two to three years have been assembled to help ensure the pilots' success. But the pilots are not an MMS-only effort. Representatives from the states of Texas and Wyoming will be intimately involved with the analysis, design, and implementation of the pilots

that concern their States. Specialists from the Bureau of Land Management and the Federal Energy Regulatory Commission will participate and add their expertise to the effort. There is lot of work for everyone to do. Our many challenges include:

- analyze lease characteristics and transportation structure in each RIK pilot area,
- define the scale and scope of each RIK pilot,
- analyze markets, legal, and operational issues in detail,
- determine marketing strategy and structure pilot program around it,
- clear any legal or regulatory hurdles,
- work with producers to sort out the details of taking the Federal share,
- determine reporting requirements and associated systems,
- design and implement production verification strategy,
- design the terms, conditions and requirements of any necessary contracts,
- select contractors and marketers, etc.

MMS's objective in the pilot program is simple and clear. Is RIK an effective and efficient method for collecting the nation's royalty revenue? MMS wants to give the concept every opportunity to succeed. As a way to reinvent government, to make it smarter, leaner, more responsive, and provide better service, RIK holds great potential. If it can live up to that potential then MMS will have lived up to its reputation as one of the most progressive, innovative and effective agencies in the Federal government.

We will have to work hand in hand with the States, industry and their associations to get this done right. We intend to share with all interested parties our draft plans, structures and thinking on the issues. MMS does not know all the answers. There are many potential ways of structuring these pilots that will meet MMS's criteria of revenue neutrality, royalty accuracy and certainty, and reduced administrative costs for all. We need to work with industry and the public to ensure we see all the possiblities. The more input we get and the closer we are able to work together, the better the RIK program will be. We hope that those interested view our effort as an opportunity to demonstrate how effective an RIK program can be for the taxpayer. Successful implementation of MMS's RIK initiatives can be an important step toward a nationwide RIK policy. Our use of pilots to pursue RIK is a prudent and pragmatic approach to the issue. As public stewards we have an obligation to collect fair value for our nation's resources. Oil and Gas royalty revenue from Federal leases contribute $4 Billion per year to the Treasury. It's not an amount we can gamble with through untested policies. By incrementally using pilots to test RIK programs, and adusting them as we go along, we can work on getting it right without risking significant Federal revenues. We are working to make government work better, and more responsibly for the taxpayer. The RIK pilot programs, with everyone's help, will help us to achieve these goals.